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# FRBSF WEEKLY LETTER

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## Agricultural Lending in the West

Agricultural lending in the West differs from that in the rest of the country in a number of important ways. First, the top eleven agricultural lenders among U.S. commercial banks, ranked by agricultural loans outstanding, are all located in the West. All are large branch banks, with assets of \$2 billion or more, and most are significantly larger. In stark contrast, small rural banks, typically with assets of \$100 million or less, supply the bulk of agricultural loans outside the West.

Another difference is that agricultural credit is more costly outside the West. Federal Reserve data on terms of bank lending to farmers indicate that in recent years western banks have on average charged lower rates on agricultural production loans than have banks elsewhere in the nation.

A final distinction between the West and the rest of the country is that portfolio risk appears to be lower for banks engaged in agricultural lending here. Unlike banks elsewhere, western banks are better able to diversify their portfolios across both agricultural and nonagricultural loans.

This *Letter* examines the key factors that may account for these differences.

### **Agricultural lending**

Farm lending generally falls into two categories, farm loans secured by real estate and agricultural production loans. Loans secured by farm and ranch land finance the purchase of agricultural real estate and to some extent, finance agricultural production, as well. However, the bulk of farm, ranch, and related agricultural production is covered by shorter-term production loans. These loans provide funds for the purchase of equipment and livestock, as well as operational expenses for a wide variety of agricultural products, including specialty crops (fruits, vegetables, nuts), row crops (corn, wheat), poultry and livestock, and even nurseries and greenhouses.

Banks provide a significant portion of the nation's agricultural credit needs, with the remainder supplied by the Farm Credit Banks, the Farmers Home Administration, the Production Credit Associations, the life insurance industry, and individuals. Banks also extend substantial amounts of credit to secondary agricultural borrowers, such as food processors and packers.

In the nation as a whole, small, rural banks supply the bulk of banks' share of agricultural credit. As of June 1989, the majority of the \$30.7 billion in outstanding bank agricultural production loans was held by small banks. And well over half of the \$16.2 billion in loans secured by farm land was held by small banks.

These banks typically have only \$35 million in assets, operate in limited geographic markets, and have portfolios that are heavily weighted towards agricultural financing. In fact, agriculture-related loans at each of these banks comprises at least 16 percent of total loans, and on average comprises nearly 42 percent. About 4,340 banks, or one-third of the nation's banks, fit this description, and are classified as "farm banks."

In contrast, the role of large banks (with more than \$2 billion in assets) is limited. Large banks outside the West account for less than seven percent of agricultural production loans, even though these banks provide about 45 percent of total loans and almost 60 percent of business loans.

These patterns do not apply to the West, however. In the West, only sixty-two banks, or fewer than one out of twelve, can be classified as an agricultural bank. Moreover, the bulk of the \$5.2 billion in outstanding agricultural production loans on the books of western banks was held by large banks. In California, large banks held \$2.3 billion in outstanding loans to finance agricultural production, or almost 88 percent of the state total of \$2.6 billion. The same pattern generally prevailed in the other western states

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(Alaska, Arizona, Hawaii, Idaho, Nevada, Oregon, Utah, and Washington), with large banks supplying nearly three-fourths of the agricultural production loans.

Large banks also dominate farm real estate lending in the West. At mid-year 1989, these loans stood at around \$1.2 billion in the West, with large banks providing almost 73 percent of those loans. In California, large banks accounted for \$585 million (or over 79 percent) of the \$739 million total.

## **Big borrowers, big needs**

Two key factors apparently account for these differences in agricultural lending patterns between the West and the rest of the country. First, borrower characteristics appear to favor large bank agricultural lending in the West. Farms are bigger in the West than elsewhere. According to the 1982 Bureau of the Census Survey of Agriculture, average farm size in the western states is about 60 percent larger than the national average. The value of farm land, buildings, and equipment per farm in the West is also much higher than the average for the rest of the nation. The average value of products sold per farm in the West, according to the survey, was about \$107,000 in 1982, about double the average for the rest of the nation. In Arizona, it was about four times the national average, and in California it was about three times the average.

"Corporate farms" partly may account for the larger average size of farming operations here, particularly since these farms typically are much larger than proprietor-owned farms. Western states report two to three times the percentage of corporate farm ownership found elsewhere in the nation.

Because farming operations are conducted on a larger scale in the West, loans need to be larger, as well. Federal Reserve data on the average size of loans to farmers show that in 1988, the average agricultural loan made by western banks was nearly \$330,000, versus a mere \$21,000 average for the nation.

Large loans are most easily handled by large banks, since regulatory lending limits severely constrain small banks' ability to offer large loans to any given borrower. For the average farm bank, with \$35 million in total assets and \$2.5

million in capital, regulatory lending limits would prohibit loans in excess of \$250,000 to a single farmer. But loans considerably larger than this are not a problem for a billion dollar bank.

## **Branch banking**

The structure of the banking industry in the West also appears to favor large bank involvement in agricultural credit markets. Outside the West, many states historically have restricted the placement of branches, typically limiting large banks to metropolitan areas within these states.

In contrast, western banks have been allowed to operate on a state-wide basis, with branches in the West's agricultural regions. In California, for example, the five largest banks (in terms of agricultural production loans), operated 329 branches, with total deposits of over \$12 billion, in the ten counties that generate two-thirds of the State's cash receipts from farm production. Thus, large banks in the West are in a favorable position to extend credit to farmers and ranchers.

## **Lower rates on loans**

In addition to the dominance of large banks in western agricultural credit markets, another feature that distinguishes the West from the rest of the country is that interest rates on agricultural loans are lower here. This appears to be largely the result of several influences. First, because lenders and loans tend to be larger in the West, overhead costs per dollar of loans are lower than elsewhere.

Second, agricultural production factors that are unique to the West permit shorter loan maturities. Specifically, the mild climate, fertile soil, and availability of irrigation water in the West provide longer, and in some cases, year-round growing cycles. Multiple harvests offer a more reliable, and less seasonal cash flow for producers. Such differences in growing cycles are reflected in the characteristics of bank loans to farmers. In 1988 the average farm loan in the rest of the country had a maturity of ten months, reflecting the preponderance of annual crop cycles. Western farm loans, in contrast, had an average maturity of about eight months, and in California, the average was about six months.

A third influence is credit risk. Although problem loans are a somewhat higher proportion of agricultural loan portfolios in the West, other

evidence suggests that credit risk in western agricultural lending may be lower than in the rest of the country. The West's diversified crop base, multiple crop cycles, and access to irrigation tend to promote stability in the agricultural sector. For example, western farmers produce a wide array of staple and specialty products that gives producers the opportunity to diversify their crop-specific risks by producing several types of crops.

Another advantage many western farmers enjoy is that they can switch crops relatively easily in response to changing market conditions. This is in contrast to producers located in areas where climate, location, or availability of water limit growing capabilities.

Moreover, the availability of irrigation provides a reliable, and typically low cost or subsidized source of water which reduces the farm sector's exposure to drought while lowering growing expenses. More than half of the cropland in the West is irrigated, versus less than eight percent for the rest of the nation.

### **Portfolio risk**

In addition to lower interest rates and the greater involvement of large banks in western agricultural credit markets, the West differs from the rest of the country in another respect. Specifically, western banks involved in agricultural lending enjoy lower portfolio risk than their counterparts do elsewhere. In the nation as a whole, troubled farm banks have accounted for from one-third to one-half of the nation's failed banks in recent years. Yet in the West, very few banks involved in agricultural lending have failed.

This apparent difference in portfolio risk partly is due to the West's diverse agricultural production base. A more important factor, however, has been the statewide branch banking structure in the West, which affords banks the opportunity to diversify risks not only across agricultural products, but across industries and geographic areas. As a result, agriculture-related loans make up only a small fraction of total loans at the biggest agricultural lenders in the West. According to a recent issue of the *American Banker*, most of the large western banks' total farm loans account for less than five percent of their total loan port-

folios. For the largest three, farm loans represent less than 2.4 percent of their total loans.

This is in sharp contrast to the concentration of farm loans at agricultural lenders outside the West, where restrictions on branching and interstate banking limit diversification opportunities. This lack of diversification made agricultural lenders significantly more vulnerable to the farm crisis of the 1980s than were agricultural lenders in the West.

### **A model for the U.S.?**

Large branch banks in the West appear to be in a favorable position with respect to extending credit to the region's farmers and ranchers. This advantage appears to result from both the nature of agricultural production and bank structure in the West. The larger scale of farm operations and borrowing and the state-wide branch structure of banking in the western states allow large banks to serve agricultural regions and to diversify agricultural lending risks statewide.

Two trends that are evident throughout the nation may be pushing agricultural lending patterns in the rest of the country to converge with western patterns. First, liberalization of interstate banking and intrastate branching restrictions likely will lead to less restricted geographic markets and may result in many states' banking market structures evolving toward market structures found in the West. The number of banks already has fallen from around 15,000 in the mid-1980s to under 13,000 today, and such consolidation will continue.

Second within the agricultural sector, consolidation into larger units also is taking place. Agricultural economists expect this trend to continue, leading to an average scale of operations in the country as a whole that is closer to the norm in the West.

Together, these trends suggest that large banks' involvement in farm lending will expand. This should reduce the risks in agricultural lending since large banks are better able to diversify risks across a wide variety of industries and areas.

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